

In the Matter of)
)
Connect America Fund) WC Docket No. 10-90

Counsel for AT&T Inc.

TABLE OF CONTENTS

	Page
I. INTRODUCTION AND SUMMARY	1
II. DISCUSSION.....	2
A. Represcription of the Authorized Rate of Return is Appropriate and Important	2
B. The Commission Should Correct the Risk-Free Rate and the Cost of Debt	4
1. The Staff's estimate of the risk-free rate may be too low	4
2. The Staff Report miscalculates the cost of debt	5
C. Other Criticisms of the Staff Report Are Unfounded.....	6
1. It is inappropriate to adopt a risk premium to reflect unique regulatory risks facing rate-of-return LECs.....	6
2. It is reasonable for the Commission to use both the DCF and CAPM methodologies to calculate the authorized rate of return	8
3. Critics of the proxies selected by staff fail to provide data that would negate the need for proxies or to suggest more appropriate proxies	9
III. CONCLUSION	10

I. INTRODUCTION AND SUMMARY

AT&T Inc., on behalf of its affiliates (collectively, AT&T), hereby files these reply comments in response to Public Notice DA 13-1110, released May 16, 2013, in which the Wireline Competition Bureau seeks comment on the Wireline Competition Staff Report, *Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers* (released May 16, 2013) (“*Staff Report*”).

The Commission last prescribed the authorized rate of return in 1990. The subsequent 23 years have seen dramatic changes in the regulatory environment, the telecommunications marketplace, and communications technology. The Telecommunications Act of 1996 introduced competition into local markets, and the Commission extended price caps in some cases and in others it removed all forms of price regulation, and recently it has effectively eliminated rate-of-return regulation for carrier switched access charges. Mobile wireless services, which were in their infancy in 1990, are now a huge and expanding part of the communications industry. Perhaps, more importantly, technological advances and the privatization of the Internet have given birth to rapidly expanding broadband networks – both wireline and wireless – that are transforming the industry. In light of these dramatic changes, it is appropriate for the Commission to represcribe the authorized rate of return.

In the initial round of comments, several parties criticized the *Staff Report* for, *inter alia*, the methodologies the staff employed, the proxies that were chosen, and for some of the data that were relied on. While a few of the criticisms are valid, most are not well founded.

Among the valid criticisms is the suggestion that the risk-free rate chosen by staff was too low. In addition, staff erred in calculating the cost of debt.

Many of the criticisms are not well founded, however. For example, the claim that staff should include a risk premium because rate-of-return local exchange carriers (“LECs”) face

unique regulatory risks is overstated. The Commission should not include a premium for regulatory risk both because regulatory risks are not unique to the rate-of-return companies and because the purported risks identified by some commenters are temporary and will be resolved once the Commission completes its reforms to universal service.

Criticisms of the use of the Discounted Cash Flow (“DCF”) and Capital Asset Pricing Model (“CAPM”) methods for computing a reasonable range for the cost of capital are likewise misplaced. Both methodologies are widely accepted and widely used. And while neither is without its individual weaknesses, using both reduces the chance of error. The Commission, however, should make transparent how the methods will be combined. For example, the Commission might simply average the results of the two methods.

Finally, some parties criticize the staff’s choice of proxies. But the critics fail to provide any data on the rate-or-return LECs themselves that would permit the staff to calculate their cost of debt and equity. Nor do they adequately explain why alternative proxies would be more representative than those selected by the staff.

II. DISCUSSION

A. Represcription of the Authorized Rate of Return is Appropriate and Important.

It is important that the Commission accurately prescribe the authorized rate of return, since, as the *Staff Report* noted, the authorized rate of return is used to determine interstate common line rates and special access rates charged by the rural LECs that remain under rate-of-return regulation. It also is used to calculate Interstate Common Line Support (“ICLS”) and to allocate High-Cost Loops Support (“HCLS”).¹

¹ *Staff Report* at ¶ 1.

The last time that the Commission prescribed the authorized rate of return was in 1990 – following Part 65 rules that provide for a unitary authorized rate of return for all incumbent LECs. These rules permitted the Commission to base its prescription on data supplied by the Regional Bell Operating Companies (“RBOCs”).²

But as the *Staff Report* observed, much has changed since then. There have been numerous significant regulatory changes, including the passage of the *Telecommunications Act of 1996*, which opened local markets to competition, the expansion of price caps, the removal of many services from price-cap regulation, consolidation of companies in the mid-size and large ILEC segments, and, most recently, the effective elimination of rate-of-return regulation for interstate carrier switched access charges. At the same time, technology and market conditions have changed dramatically. Where mobile wireless was in its infancy in 1990, it has grown into a robust and competitive industry that now has over twice as many subscribers as wireline companies.³ In 1990, the National Science Foundation had yet to commercialize the Internet, but by June 2012, there were more than 100 million Internet connections with speeds of at least 3 Mbps downstream and 768 kbps upstream (and 243 million Internet connections with speeds over 200 kbps in at least one direction).⁴ And as broadband networks have been widely deployed and as broadband services have been eagerly adopted, IP technologies are rapidly rendering circuit-switched technologies obsolete. Finally, over this 23-year period, both interest rates and the cost of capital have undergone significant changes.

² See 47 C.F.R. §§ 65.100 & 65.300.

³ Industry Analysis and Technology Division, Wireline Competition Bureau, *Local Telephone Competition: Status as of June 30, 2012* at Fig. 1 (June 2013)

⁴ Industry Analysis and Technology Division, Wireline Competition Bureau, *Internet Access Services: Status as of June 30, 2012* Tables 1 & 2 at 17 (May 2103).

Given these changes, the Commission should reassess the authorized rate of return. As the *Staff Report* noted, the allowed rate of return “must be high enough to provide investors and creditors confidence in the ‘financial integrity’ of a carrier, so that it can maintain its creditworthiness and attract capital.”⁵ On the other hand, it should not be set higher than necessary, since this would result in unnecessarily high and distortionary prices for end-user and carrier customers and excessive demands on the Federal Universal Service Fund.⁶

B. The Commission Should Correct the Risk-Free Rate and the Cost of Debt.

Two of the criticisms raised in the initial round of comments have merit. First, it appears that the risk-free rate selected by staff may be too low. Second, it appears that staff miscalculated the cost of debt.

1. The Staff’s estimate of the risk-free rate may be too low.

Under the CAPM formula, the risk-free rate of return plays a critical role in determining the cost of equity.⁷ As several commenters point out,⁸ however, the way that the *Staff Report* calculates the risk-free rate of return results in an estimate that is artificially low.

As the United States Telecom Association points out in comments filed in the Virtual Workshop, the Staff chose to use the ten-year Treasury rate for a single day in March 2013.

⁵ *Staff Report* at ¶6.

⁶ *Id.*

⁷ As the *Staff Report* notes, under the CAPM formula, the required return on equity equals the risk free interest rate plus Beta times the market premium (or $E(r_i) = r_f + \beta_i * [E(r_m) - r_f]$, where $E(r_i)$ is the required return on equity for firm i , r_f is the risk free return, β_i is the beta for firm i , and $E(r_m)$ is the expected market return. See A. LAWRENCE KOLBE, JAMES A. READ JR. & GEORGE E. HALL, THE COST OF CAPITAL: ESTIMATING THE RATE OF RETURN FOR PUBLIC UTILITIES at 70 (1984) (“KOLBE, READ & HALL”).

⁸ See, e.g., National Exchange Carrier Assoc. *et al.* Comments at 27 (“NECA *et al.* Comments”); Alaska Rural Coalition at 10; GVNW Consulting Comments (“GVNW Comments”) at 6; United States Telecom Comments in Virtual Workshop (filed June 20, 2103) (“US Telecom Virtual Workshop Comments”) at 5-6.

There are two reasons to doubt that this is a reasonable estimate. First, the use of a one-day snapshot of the ten-year Treasury bond rate taken in March fails to acknowledge that interest rates were at historic lows at that brief moment. In fact, since March, the ten-year rate has risen almost a full percentage point. Second, due to daily volatility in markets, a one-day snapshot, while possibly an unbiased predictor of future rates, has a higher variance than is desirable. Indeed, the Commission's threshold for investigating whether the authorized rate of return needs represcription looks at monthly average yields on Treasury securities over a six-month period.⁹ Thus, it would be more reasonable for the Commission to measure the risk-free rate by using, say, an average of twenty-year Treasury bond rates over the past six months.

2. The *Staff Report* miscalculates the cost of debt.

The *Staff Report* concluded that the cost of debt should be based upon values and interest costs reported by the companies in their annual reports to the SEC. The Staff further concluded that the current rule's formula for calculating the cost of debt contains an error. Staff's identification of the error in the rule was correct, but Staff then made another error in actually calculating the cost of debt. As U.S. Telecom explained:

[T]he embedded rate was developed from 2012 interest expense divided by the average of outstanding non-current long-term debt at the end of 2011 and 2012. This approach understates the total amount of debt and overstates the cost of debt by excluding the current portion of long-term debt on which the carriers continue to pay interest.¹⁰

⁹ 47 C.F.R. § 65.101(a).

¹⁰ U.S. Telecom Virtual Workshop Comments at 7.

The Commission thus should include the current portion of long-term debt when calculating the cost of debt.¹¹

C. Other Criticisms of the *Staff Report* Are Unfounded.

While the criticisms of the Staff's calculations of the risk-free rate and the cost of debt are valid, other criticisms raised in the initial round of comments appear unfounded.

1. It is inappropriate to adopt a risk premium to reflect unique regulatory risks facing rate-of-return LECs.

Several parties contend that the Staff's approach to estimating the cost of capital fails to capture the regulatory risks that rate-of-return LECs currently face.¹² These commenters point to the Quantile Regression Analysis ("QRA"), which they argue creates uncertainty as to how much High Cost support individual rural rate-of-return LECs will receive, and to the current absence of a Connect America Fund Phase II plan for rate-or-return LECs. This regulatory risk, they argue, is borne only by rate-of-return carriers and not by price-cap carriers.¹³

It would not be appropriate to adjust the cost of capital to reflect this transitory regulatory risk, for a number of reasons. First, all carriers face significant uncertainty in many dimensions,

¹¹ Alexicon Consulting suggests that the *Staff Report's* estimate of the forward-looking cost of debt may be understated because the Federal Reserve in 2008 adopted a monetary policy designed to keep longer-term interest rates down. Alexicon Comments at 8-9. But the *Staff Report* based its cost of debt estimate on the book value of debt and the companies' debt interest payments. Alexicon provides no evidence concerning the percentage of debt that the proxy companies incurred during this period of lower interest rates since 2008. Since it is impossible to estimate the impact of the recent Federal Reserve Policy, this factor should be ignored in calculating the cost of debt. Additionally, CoBank takes issue with the assertion that it provides loans at below-market rates. While CoBank's nominal interest rates may be market-based, CoBank fails to acknowledge that its non-profit cooperative organization allows it to return earnings to its owner-borrowers in the form of patronage dividends that have the effect of reducing the costs of loans to below-market rates.

¹² See, e.g., NECA *et al.* Comments at 19-20; Alaska Rural Coalition Comments at 5; GVNW Comments at 6; Moss Adams LLP *et al.* Comments ("Moss Adams Comments") at 15; JSI Comments at 4.

¹³ See, e.g., NECA *et al.* Comments at 17-19; John Staurulakis, Inc. Comments at 4 ("JSI Comments"); Moss Adams Comments at 15.

including regulatory dimensions. For example, all carriers face uncertainty regarding the rules that will apply to VoIP and other IP-based services as the industry transition away from TDM-based services. Carriers likewise face continual and substantial uncertainty in the dynamic communications marketplace from the ever-present threat of competition from old and new sources, shifting consumer demands and preferences, and rapid obsolescence of existing infrastructure. Given the many different kinds of uncertainty that all carriers face, it would be inappropriate to single out for special favorable treatment one particular risk for one group of carriers. Indeed, one might argue that the overall regulatory risks faced by rate-of-return LECs are intrinsically less than those faced by a number of the proxy companies that operate under the Commission's price cap rules, since the price-cap rules provide those proxy companies with no assurance of earning a particular rate of return.

Second, these commenters provide no evidence demonstrating that these regulatory risks are not already taken into account in the growth projections and market expectations that underlie the cost of capital methodologies.

Third, under the Commission's rules, rate-of-return LECs always have the option of converting to price-cap regulation. Thus, if the risks of rate-of-return regulation in fact were greater than those faced by the proxy group (that includes price-cap LECs), as some commenters suggest, one would expect to see numerous rate-of-return carriers converting to price caps. That this seems not to be occurring suggests that the actual risk balance is different from what these commenters claim.

Finally, it is inappropriate to include a premium for a "temporary" risk when the authorized rate of return is likely to continue to be used well after this particular type of uncertainty has been eliminated. Rather than include a premium to compensate for temporary

regulatory uncertainty, the Commission should simply complete its reforms to the Universal Service Fund as expeditiously as possible.¹⁴

2. It is reasonable for the Commission to use both the DCF and CAPM methodologies to calculate the authorized rate of return.

The DCF and CAPM methods of estimating the cost of capital are both widely accepted and widely used methodologies.¹⁵ But both methods have their individual limitations.

Both require estimates of variables that may not be observable. For example, the DCF method requires estimates of the growth rate of dividends over future time, which is not currently observable.¹⁶ In addition, the DCF method cannot be used for companies that pay no dividends.¹⁷ Similarly, the CAPM method has been criticized for not always accurately

¹⁴ Nor is it appropriate, as some commenters suggest, to add a premium to the proxy-developed cost of capital for rate-of-return LECs because generally they are smaller companies. *See, e.g., NECA et al. Comments at 28-29; Alexicon Consulting Comments at 18-23; Alaska Rural Coalition at 9; NTTA Comments at 7-8; Moss Adams Comments at 22.* First, the majority of rate-of-return carriers are members of the NECA pools. The NECA pools allow its members not only to pool their costs and revenues, but also effectively to pool their risks. Since the capital assets underlying NECA's cost pools currently amount to almost \$3 billion, this risk-sharing mechanism shields individual rate-of-return carriers from the risks that might be associated with smaller firms. Second, any risks that the smaller-rate-of-return LECs might face based on their size are further reduced by their rate-of-return status that protects them against under-earning – as well as the presence of the Federal Universal Service Fund and its true-up mechanisms. Third, some rate-of-return LECs have established holding company structures and resemble larger firms in terms of market and product diversification. *See Universal Service Fund: NECA Study Results* (<http://transition.fcc.gov/wcb/iatd/neca.html>) (showing that at least 90 holding companies operate 376 of 1132 reported study areas, representing about 35% of rate-of-return carrier access lines). Finally, many of these rate-of-return LECs may be subject to lesser market risks, since they tend to serve more rural and less densely populated areas where competition has been slower to develop or has yet to develop. For these reasons, the Commission should not apply a risk premium to the cost of capital faced by rate-of-return LECs allegedly because of their smaller size.

¹⁵ *See, e.g., Staff Report at ¶¶51 & 95; see also KOLBE, READ & HALL, at 53& 65; Alexicon Consulting Comments at 5-6.*

¹⁶ *See, e.g., KOLBE, READ & HALL at 54-55.*

¹⁷ *Staff Report at n. 156.* Staff acknowledged this problem by excluding certain companies from its DCF analysis, where there were no long-term growth forecasts, where the companies did not pay common stock dividends, or whether the estimated growth rate yielded a cost of equity less than the cost of debt. *Id.* at ¶¶ 101-02.

predicting equity returns,¹⁸ and questions have been raised about whether its β coefficient truly captures all the risk factors associated with a company.¹⁹

Since both methodologies suffer from some weaknesses, and neither appears clearly superior to the other, it would be reasonable to employ both in estimating the zone of reasonableness. However, it would be helpful for the staff more explicitly to identify how both methods are to be used to generate the final results. For example, one might simply average the results from the two methods together.²⁰

3. Critics of the proxies selected by staff fail to provide data that would negate the need for proxies or to suggest more appropriate proxies.

Some parties representing rate-of-return LECs argue that the companies whose data the Staff chose for its cost of capital analyses are not good proxies for rate-of-return LECs.²¹ However, these critics neither provide data that would negate the need to rely on proxies nor suggest proxies that would be more representative of the rate-of-return LECs.

As the Commission has noted in its previous representations and in the *Staff Report*, scant reliable data are publicly available to develop a cost of capital specific to rate of return-regulated LECs.²² Nor have the rate-of-return LECs submitted into the record of this proceeding data relating to their own operations, such as their cost of debt and past distributions of dividends, that

¹⁸ *Staff Report* at ¶ 61.

¹⁹ KOLBE, READ & HALL at 74-75; ROGER A. MORIN, NEW REGULATORY FINANCE at 175-76.

²⁰ Cf. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCCR 15499, 15896-97 (setting proxy loop rates for unbundled local loops by computing a "simple average of the scaled cost estimates for the two [cost] models.")

²¹ See, e.g., NECA *et al.* Comments at 20-25; Alaska Rural Coalition Comments at 9; JSI Comments at 3-4; National Tribal Telecommunications Association Comments at 7-9.

²² See, e.g., *Staff Report* at ¶ 24.

would permit the Commission to calculate a cost of debt or equity for rate-of return LECs specifically.

In addition, critics have failed to demonstrate that the alternative proxies proposed by NECA are more representative of the rate-of-return LECs.²³ These alternative proxies include large U.S. and foreign corporations, none of which is a telecommunications company. As the *Staff Report* noted “the proxy companies are facially quite dissimilar to the rate-of-return incumbent LECs.” The *Staff Report* thus is correct to conclude that the NECA proxies “have little business resemblance to rate-of-return carriers” and that this “makes them less suitable proxies because foreign, non-incumbent LEC companies do not face the same market risks or regulatory structure that rate-of-return LECs face.”²⁴

III. CONCLUSION

It is appropriate to prescribe a new authorized rate of return, particularly because it has been 23 years, since the Commission last prescribed the authorized rate of return. The initial round of comments identified two mistakes in calculating the risk-free rate and the cost of debt, which the Commission should correct. However, other criticisms of the *Staff Report* are unfounded. Specifically, the Commission should not adopt a risk premium to reflect regulatory risks facing rate-or-return LECs. The Commission’s use of both the DCF and CAPM

²³ NECA *et al.* Comments of January 18, 2012 at App. C, Statement of Prof. Randall S. Billingsley, Attach. 3.

²⁴ *Staff Report* at ¶ 30.

methodologies to calculate the authorized rate of return appears reasonable. Finally, the criticisms of the proxies selected by staff are misplaced.

Dated: August 26, 2013

Respectfully submitted,

Christi Shewman
Gary L. Phillips
Peggy Garber
AT&T Inc.
1120 20th Street, N.W., Suite 1000
Washington, D.C. 20036
(202) 457-3090

/s/ Donald K. Stockdale, Jr.
Donald K. Stockdale, Jr.
MAYER BROWN LLP
1999 K Street, N.W.
Washington, D.C. 20006
(202) 263-3000